Panel Session – Do hybrid plans offer a better allocation of risk, and are they a feasible way forward?

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Thank you to AARP for putting together this dialogue on hybrid plans. As I was walking here today, I thought we could give this subject more pizzazz, by tying our speeches into the British literary phenomenon sweeping the globe and rename this session: "Harry Potter and the cash balance prince…or Harry Potter and the Prince of Pensions." I guarantee if we did, we would have had millions of people here today – instead of 40.

The synopsis of our book (presumably the last in the series) would be something like this: "Hogwarts, the school of wizardry, is facing global competition and finds traditional db plans too burdensome and costly. Yet the employees of Hogwarts much prefer the traditional db plan because it is employer-paid and provides guaranteed income when the professors – such as Professor McGonagal or the lovable teacher Hagrid -- get too old to teach.

The wizards, recognizing the pressures of a changing economy, wave a magic wand to create new plans that combine the best of old plans with some of the features of the new….and hybrid plans are created. They become the wave of the future and everybody is happy."

Of course that's the wizard's world. In the muggle world, the non-wizard world in which we all presumably reside, everything is a bit more complicated. The story of cash balance plans in the US is nuanced and has differing points of view depending on who's telling the story. While Jim has told the story of hybrids from an employer perspective, I'd like to share my perspective on hybrids in this country from an employee perspective. There are places where we agree and places where we may not agree. I'll talk about why hybrid plans, if design and legal issues are resolved, may be good for the future; and I'll talk about how conversions to these plans have created a storm of controversy – that hopefully can be avoided in the UK. And I'll talk about what a good hybrid plan can look like.

I think any pension reform proposal should adhere to what I read in the he Principles of Pension Reform for the Department of Work and Pensions: " The challenge as we look to the future is how to ensure, in a world of growing longevity, that all of today's working-age generation….have the best possible opportunity to build adequate incomes." That is the shared concern of both the US and the UK.

There is no question that to address our aging society, and to develop ways of adequately providing for current and future generations of retirees, we need to think creatively and develop new kinds of plan designs. The old traditional defined benefit model --while an efficient benefit delivery system-- is getting costly for employers and is not as popular as it used to be; the 401(k) plan, while popular, puts all the onus on employees to save and statistics show that do-it-yourself savings will likely not lead to adequacy in retirement -- since most people are saving way too little to accumulate a needed supplement to Social Security.

So creating a new model that combines features of db plans and dc plans has appeal. We certainly believe that creating an <u>employer-funded portable, lower-cost hybrid plan</u> <u>that provides guaranteed benefits is a model for the future.</u> However, to move forward with the right kind of hybrid in the future we first have to address the back story. <u>Cash balance plans, while often promoted as the panacea of the pension system in the US, are mired in controversy</u>.

Over the past six years, we've heard from thousands of workers from huge corporations – IBM, Bell Atlantic, Cigna, Citibank, AT&T and others – <u>who have been devastated by the conversion of their traditional defined benefit plan to a cash balance plan.</u> These workers discovered, much to their horror, that cash balance plan conversions have reduced their expected benefits by as much as fifty percent.

The individuals I'm talking about are loyal, hard-working employees who lived the proverbial American dream. They worked years and years for healthy, stable companies and were told explicitly by their employer that if they stayed and did their job, they would be rewarded with a pension based on all their years of work (typically based on final pay as well as, in many cases, subsidized early retirement benefits if they met specific conditions under the plan). They thought as long as they met their end of the deal, the company would honor their promise as well.

But overnight, older employees in their 40s and 50s had the rug yanked from under them.
Employers told them not to worry about the conversion, that the cash balance plan would offer them better benefits, portability and transparency. Yet, older employees too often found the opposite to be true: They were subjected to an array of extraordinarily complex and mystifying formulas and practices -- that masked in obfuscating language – had the sole effect of reducing their rate of future benefit accrual, <u>eliminating their subsidized early retirement benefits and, in many cases, freezing their benefits so they could not earn additional benefits under the cash balance plan.</u>

These employees rightly felt betrayed. They asked **"How can employers change the rules half way through the game?"** They asked us how they were expected to make plans for the future if they can't rely on what they viewed as promises made to them. While employers contend that they need flexibility and predictability, employees, especially in their later years, need predictability too. How can people plan for the future if they can't rely on the implicit contract made to them?

The fact is, that while employers say that cash balance and other forms of hybrid are better for mobile workers – and maybe in the future some sort of simplified plan might be – employees contend that this rationale is an afterthought, designed to justify plans that were created by consultants for the purpose of enabling companies to cut benefits of older employees without the substantial adverse tax, accounting AND worker morale consequences of A direct PLAN termination.

Some commentators have suggested that another reason for conversions is that it helped companies, sitting on large surpluses in their pension plans in the 1990s, to reduce their liabilities under their plans and, by dint of accounting practices, bolster their bottom line. <u>Employees point out that if companies had wanted to help younger workers, they would have set up these plans anew (not in conversion) and simply allowed older employees to stay under the old plan.</u>

These practices led to protests in this country that were unprecedented in the pension arena. Suddenly, once docile employees, Izod-wearing mid-managers were staging protests that were dubbed by the newspaper USA Today and the AARP News Bulletin "as an employee pension revolution." Protests led to Congressional hearings, the introduction of legislation and an IRS moratorium on issuing approval of these plans.

There are a host of pending class action lawsuits charging that cash balance plans and cash balance conversions are age discriminatory AND VIOLATE SEVERAL TECHNICAL PROVISIONS OF THE LAW. . And the judge in one the biggest cases, IBM, has agreed with the employees. Now on the legal issue, Jim and I will sing different songs (I say tomato, he says tomoto) or "I say unlawful, He says they're lawful." The fact is, without getting into the details that are highly technical, there is now legal uncertainty around these plans

This brings us to where we are now. Do cash balance plans make sense for the future and should they be legitimized for the future? The fact is, Congress has never authorized these plans and they were never envisioned by Congress when they passed the federal private pension law in 1974. The law only recognizes either a db plan or a dc plan. If we're going to envision new kinds of plans, be they cash balance plans or other kinds of hybrids, we have to do a full review of the rules, which work, which don't on funding and structure to avoid new problems in the future.

So in our country, Congress now has an opportunity to legitimize cash balance plans through the creation of a regulatory regime that works well for the cash balance form and which protects reasonable expectations of older workers who might otherwise be hurt by conversions. Here's what we need:

- **<u>Adequate transition rules that protect older employees</u>**
    a. (for instance a choice between the old plan and new plan for people who meet certain age and service requirements; or grandfathering of people who meet certain age and service requirements).
- **<u>Adequate and plain English disclosure so people can see what they're getting and what they're losing</u>** (Note: many employers who convert now have done it "the right way." Congress can look to the best employers to set minimum standards for an ethical conversion).
- **<u>Prohibit the practice (wearaway) where employers are allowed to freeze or eliminate pension benefits of older employees.</u>**

Also, for cash balance plans to be authorized in the future, in a non-conversion process, we have to balance the interests of employer and employees:

- One area of concern is that employees receive a reasonable interest credit and not, as some plans provide, the low rate on government-backed debt instruments –or employees might do as well under a 401(k) plan. We want to make sure individuals understand that low interest credits in effect reduce the value of high pay credits. Thus, we believe that cash balance plan rules should define minimum interest credit rates that can be used in a plan.
- And we also believe that cash balance benefits should be vested in three years – and not integrated with Social Security (In the U.S., we allow companies to subtract a portion of SS benefits from an employee's pension, often reducing its value substantially, which we think is unfair, and counter to good pension policy.

- **Cash balance plans should be easy-to-understand. Predictable for employers and predictable for employees.**

I should add that, apart from discussion today, the PRC has spearheaded an initiative, called the Conversation on Coverage which is looking for ways of expanding pension coverage for low and moderate wage-earners. We've brought together experts of varying perspectives – ABC and AARP are both involved – and come up with recommendations. One recommendation should be of particular interest to people in this room. GAP, a recommendation from one Working Group is hybrid – starting with a money purchase plan adding guarantees, It is an:.

a. Existing money purchase plan and adds a guaranteed account balance.
b. Accounts are credited with an annual employer contribution
c. Benefits are funded by employers, based on standardized and conservative funding assumption,
d. Employees can also elect to contribute in a 401(k) type arrangement.

e. Plan guarantees the annual rate of return on participants' account balances.
f. Simple and predictable funding for employers; simple and guaranteed benefits for employees.

The GAP idea and others is in the Conversation on Coverage report and can be found at www.pensioncoverage.net.

In conclusion, as the UK moves forward in designing and promoting hybrids, we hope that you will learn from the US experience. We hope that you'll create simple and fair plans that take into account both the interests of workers and employers. We hope you will heed our experience and ensure that if companies convert to different plans midstream that you ensure that older employees are protected and new plans for new workers.

To move ahead, and develop solutions for today's aging workforce, there is no question we need to find new structures and new ideas. We may not have magical solutions, like in Harry Potter, but we can work together to find the right solutions for the future.